



Management of Accounts Receivable

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Preface

This guide accompanies the Auditor-General's Audit Report No. 29, *Management of Accounts Receivable* in the Commonwealth. It is intended to provide an overview of the current trends and "better practice" approaches that are being adopted by organisations in managing accounts receivable.

In the commercial world the way in which organisations manage their accounts receivable has significant implications for the financial health of those

organisations.

This creates an imperative to ensure the management of receivables is both efficient and effective. The practices used in common business processes such as accounts receivable management have universal application and are not industry specific. In this regard there are lessons to be learned by others from the practices followed by organisations for whom accounts receivable is a core business process. The better practices discussed in this guide are therefore recommended for consideration by Commonwealth government agencies.

Not all of the practices outlined in this guide will suit each agency's circumstances, however, it is considered that most agencies, which derive revenue on sale of goods and services on credit terms, will benefit from benchmarking their current practices against those detailed in the guide.

Introduction

Effective management of accounts receivable presents important opportunities for agencies to achieve strategic advantage through improvements in customer service, cash management and reductions in costs.

The primary objective of accounts receivable in the Commonwealth public sector is to collect monies due and to assist in meeting cash flow requirements. An effective accounts receivable function can assist in achieving the desired cash flow outcome through the timely collection of outstanding debts.

All agencies also have an objective of continually improving customer service. A large number of agencies which operate as businesses are required to perform public services under a full or partial cost recovery arrangement. Effective accounts receivable management can assist agencies improve customer service through providing timely information on customer requirements and by making dealing with the agency as easy as possible.

All government agencies, including those operating in a monopoly, are required to demonstrate contestability - that is delivery of a high quality standard of service at a cost that is comparable to providers of similar services operating in similar environments. Improvements in accounts receivable management which reduce

the cost of collecting monies can improve an agency's ability to demonstrate contestability and accountability.

Importance of Organisational Culture

An international receivables management benchmarking study commissioned by the Australian Taxation Office has highlighted the importance that organisational culture has in the successful management of accounts receivable. The study, which involved the survey of five international taxation agencies and eight domestic organisations for which accounts receivable is a strategic issue, indicated that management attitudes need to support practices for minimisation of debt.

All agencies should adopt a culture whereby staff are encouraged to obtain payment, where required, and not just focus on program or service delivery.

The Accounts Receivable Process

A typical accounts receivable process is mapped below.

The process commences with a receipt of a customer order and ends with the collection or write off of a debt.

Financial management functions such as accounts receivable have been traditionally viewed as transaction processing activities. An international benchmarking study referred to in the *Paying Accounts Better Practice Guide* issued by the ANAO in November 1996 indicated that up to 65 per cent of time was spent on non-value added activities across all government and industry sectors. The study suggested that the elimination or reduction of non-value tasks can be effected through better work practices and automation of processes. This can be achieved by analysing current processes and redesigning them to remove as much manual intervention as possible, reducing rekeying and appraisal activities and minimising operator error. An important part of this analysis is a formal, structured risk assessment which identifies and measures exposures associated with the accounts receivable process.

The following diagram highlights the opportunities available for improvement

through better practices.

Significant advances in accounts receivable performance and process efficiency are available to agencies through the following five complementary key management initiatives:

- Re-engineering accounts receivable
- Risk assessment
- Use of advanced technology
- Debt collection processes
- Performance Measurement

These matters are addressed in the following chapter.

Re-engineering accounts receivable

Some large private sector organisations have achieved real cost reductions and performance improvements by re-engineering the accounts receivable process. Re-engineering is a fundamental rethink and re-design of business processes which incorporates modern business approaches.

The nature of accounts receivable is such that decisions made elsewhere in the organisation are likely to effect the level of resources that are expended on the management of accounts receivable. An illustration of this point is the extra effort that must be put into debt collection where credit policy is poorly administered or too freely given. The strong linkages between different processes means that true improvements cannot be achieved without focussing on all aspects of the management of accounts receivable.

The following better practices present opportunities to improve the accounts receivable function.

Centralised Processing

A better practice for the delivery of finance services is the adoption of centralised processing for finance functions such as accounts payable and accounts receivable. Centralised processing groups are typically high volume transaction processing centres servicing multiple operating groups. Their establishment

achieves a number of benefits for the organisation. These include the achievement of a high degree of specialist expertise in the function supported, the establishment of centres of excellence that develop and enforce common practices and standards and the achievement of cost efficiencies through the co-locating of systems and staff. The establishment of these centres also frees up other staff for more value adding work.

One private sector firm reduced its total finance staff numbers by 12 per cent through centralised processing.

Standing Payments

Research into better practice indicates that repayment rates are significantly enhanced by providing customers and debtors with alternative payment approaches. In addition to there being alternative payment methods there are also alternatives to issuing invoices in the traditional accounts receivable processing approach. These alternative payment strategies result in efficiencies in the management of accounts receivable.

An approach that is available to agencies which deliver services on a regular basis resulting in recurring invoicing and receipting cycles is to arrange for the provision by customers of standing payments. An annual or bi-annual settlement can be undertaken to reconcile payments to services provided. The process can be facilitated by providing customers with regular updates of fees charged.

The benefits of this approach to the service providers is the reduction of costs through the removal of the need for an invoicing and debt collection function and the more timely receipt of revenues. There is also benefit to the customer through the streamlining of payment processes. The approach is most effective if adopted in conjunction with payment by direct debit of customer bank accounts.

Alternative payment options

Private sector organisations and public authorities are finding that payment of accounts outstanding is likely to be quicker where a number of payment alternatives are made available to customers. They also find that the availability of convenient payment methods is a marketing tool that is of benefit in attracting and

retaining customers.

The following modern payment methods are available and provide the benefits of added customer service, reducing remittance processing costs and improving cash flow through faster debtor turnover.

Direct debit - involves authorisation for the transfer of funds from the purchaser's bank account; this approach has the advantage of reduced processing costs, however it can present security exposures.

Integrated Voice Response - a system which combines use of human operators and a computer based system to allow customers to make payments over the phone, generally by credit card; this system has been proved highly successful in organisations which process a large number of payments regularly.

Outsourced Agency Collection - payments are collected by an external agency under a contractual arrangement (eg. Australia Post). The payment method under this approach can be either cash, cheque, credit card or EFTPOS. This method increases flexibility and convenience to the customer which may lead to improvements in the rate of payment. A variant on this approach is *BPAY*, a system whereby banks act as outsourcing partners by collecting payments from suppliers' customers and directly crediting supplier accounts.

Lock Box processing - an outsourced partner captures cheque and invoice data and transmits the file to the client agency for processing in that agency's systems. This approach transfers the cost of data collection to service provider.

Other payment methods such as use of data kiosks by customers in public use areas and payment for goods and services via the Internet are likely to become readily available in the near future.

Each of the above payment types have advantages and disadvantages which are likely to be peculiar to the environment that particular agencies operate in. Agencies need to balance the benefits in both the payment and receipting processes against the costs that some payment options may present to the agencies themselves.

Marketing and educational activities can be used to promote timely payment. Agencies should provide information on the nature of products or services available, the required payment cycle, payment options available and the consequences of non payment.

Customers should be aware of their liability at all times. A practical way of achieving this objective is the issue of monthly customer statements.

Use of Payment Incentives

Private sector practice has been to, over time, reduce the level of reliance on discounting as an incentive for prompt payment. However, the practice is still used in government instrumentalities in Australia and should be considered by agencies which have problems with debtor turnover. Discounting can be used as an incentive for customers to pay upon receipt of services, thereby avoiding the use of credit terms.

Whilst discounting has the advantage of potentially shortening the average collection period it also reduces net revenue. Before deciding to offer discounts agencies should conduct an analysis of the effect that the utilisation of discounting will have on net revenue. This estimate should be balanced against the costs of continuing to hold receivables at their existing levels, which is effectively the market interest rate applied to the annual carrying cost of receivables. Another issue for consideration is the alternative uses to which the funds tied up in receivables could be put.

In addition to developing a range of incentives for early payment agencies should consider the imposition of penalties on late payment. In designing penalties agencies should be aware of legislative and policy considerations which may reduce the potential for major penalties such as removal of service.

Case management approach

Where individual customers have strategic importance to the agency a case management approach may be adopted to the management of the agency-customer relationship. Under this approach all aspects of the relationship are drawn together including debt management. The increased knowledge of the

customer that derives from the adoption of a case management approach can assist in the design of strategies for the prompt repayment of debt.

Risk assessment

Risk assessment is a major component in the establishment of an effective control structure. Once risks have been properly identified, controls can be introduced to either reduce risks to an acceptable level or to eliminate them entirely. A proper risk assessment also creates opportunities for freeing processes from inefficient practices.

In managing accounts receivable the key areas that management should focus on for the purpose of conducting a risk assessment are:

- debt management processes, and
- outstanding debts and debtors.

Debt management processes

The risk analysis involves a re-think of processes and questioning the way that tasks are performed. A risk assessment opens the way for efficiency and effectiveness benefits in the management of accounts receivable. In particular, processes can be re-designed to achieve the following benefits:

- the establishment of clear and concise policies for issuing credit and for recovery of debt;
- the removal of non value adding tasks and clarification of roles and responsibilities, by, for example, streamlining delegations;
- the establishment of controls where exposures are noted;
- allowing staff to apply more initiative and ingenuity to every day tasks; and
- the identification of new and more effective ways of delivering services.

A credit policy document is a key component of the accounts receivable control environment and needs to cover all aspects of revenue and debt collection practices. It needs to be:

- written in plain English so that it is understandable by staff and customers;

- accessible to all staff who are required to administer it; and
- made available to customers in summary form.

In addition, it should

- establish a financial threshold under which it is uneconomical to pursue recovery action;
- set down criteria against which a debt might be considered for waiver;
- be kept up to date. This means it should be reviewed at regular intervals so that consideration can be given to incorporating new practices or initiatives, and
- be endorsed by executive management.

Agencies should be aware that the credit term set in a credit policy will have a direct impact on their terms of trade.

A checklist of features which should exist within a good policy document is included as an appendix to this Guide.

Outstanding debts and debtors

The application of a credit policy will not be fully effective unless there has been a comprehensive risk analysis of the customer population performed. This can be achieved by having detailed information on the characteristics of customers (and potential customers) and through the establishment of criteria against which to assess the credit worthiness of individual customers.

The criteria needs to be laid out in the credit policy. Sufficient information on customers will need to be held on a comprehensive customer database. Key components of the database are:

- billing name and address;
- credit information;
- place of purchase;
- date of purchase;
- special service requirements (will vary with the nature of the service);
- method of payment;
- payment history; and

- customer type.

This database will need to be regularly maintained and updated.

Use of Advanced Technology

Advances in technology present an opportunity for improvement in accounts receivable processes. The principal innovations available are the integration of systems used in the management of accounts receivable, the automation of debt collection processes and the use of electronic commerce.

Systems Integration

Improvements are available from the integration of the revenue and accounts receivable systems. This integration results in remittances being automatically credited against a customer account with a simultaneous update of the general ledger. This process avoids the downloading of data and re keying.

A fully integrated system could exhibit some or all of the following features:

- electronic invoice; which extracts details from database of approved customers, credit terms and which is authorised electronically;
- quantity, price and account code for sales entered once only, on invoice;
- electronic notification of delivery of goods/services;
- customer and account code details extracted automatically from customer order for payment;
- automation of reminder letters, and
- automatic triggering of write-off or waiver action.

Electronic Commerce

Electronic commerce is a term applied to the use of computer and telecommunications technologies, particularly on an inter organisational basis, to support trading in goods and services. It uses technologies such as electronic data interchange (EDI), electronic mail, electronic funds transfer (EFT) and electronic catalogue systems to allow the buyer and supplier to transact business by exchanging information between computer applications systems. This achieves cost savings by removing the need for direct negotiation between the parties.

The Commonwealth government has required departments, through its *Commonwealth Electronic Commerce Service*, to ensure that all suppliers and potential suppliers of goods and services are given the opportunity to transact their business electronically. In its Statement of Direction on electronic commerce issued in July 1996 the government noted:

"There is, in addition, an unrealised potential for the wider application of other electronic commerce technologies."

The Statement indicated that individual departments should:

"take account of the opportunities offered by electronic commerce in their business planning processes, and include in their information technology and telecommunications strategic plans relevant provisions covering the use or intended use of electronic data interchange both for core functions and in support applications."

The objective of the *Commonwealth Electronic Commerce Service* to date has been to promote the use of electronic commerce by government agencies in purchasing. It is proposed to extend the system to payment of accounts in the near future. In situations where the government service recipients are other government agencies or non government organisations which operate IT systems which have electronic commerce capabilities the potential exists for use of electronic commerce in accounts receivable. This potential is likely to increase in the future.

Debt Collection processes

Debt collection processes should be undertaken with the objective of reducing outstanding accounts while keeping sight of the need to maintain customer goodwill, in an environment of cost restraint.

Better practice in debt collection includes the following:

- assessment of debts against a financial threshold before proceeding with recovery action;

- review of the accuracy of invoices following failure by debtors to respond to a letter of demand;
- categorise debtors in accordance with their ability and willingness to pay. Tailor debt collection processes in accordance with results of this analysis;
- prioritise debt on the basis of risk indicators. The indicators could include the payment history of the customer, debt level, demographics, etc;
- communicate directly with debtors most probably by phone and obtain personal commitment as to repayment schedule;
- staff have the authority to negotiate payment options within guidelines, without further approval from management;
- treat debt collection as a specialist function. Recruit specialists as required and provide appropriate training; and
- consider outsourcing all or part of the debt collection process to a private collection agency. Where debt collection is outsourced agencies should ensure that the *Information Privacy Principles* as laid down in the *Privacy Act 1988* are complied with.

Of vital importance in the design of debt collection procedures is the need to be proactive about the recovery process. Credit industry advice is that the more a debt ages, the greater is the risk of non recovery. Estimates are that allowing a debt to age more than 90 days increases the risk of non recovery by at least 20 per cent.

Performance Measurement

An integral part of the re-engineering of any finance function is to develop a suite of indicators which will measure progress over time.

The following tables may be used by agencies both to establish performance indicators and to measure improvements which result from re-engineering the accounts receivable process. Each list should be modelled and adapted as necessary to suit the requirements of individual agencies.

Table 1 is an example of a type of value analysis. Under this approach the data on time spent on each part of the process would most likely be based on

estimates. The benefit of this approach is that it makes clear to managers the proportion of time that is spent on non value adding activities in the accounts receivable cycle. This type of analysis is not an absolute indicator of cost effectiveness of processing as it takes no account of costs, however, it does demonstrate the interrelationship between the various steps in the process and therefore opportunities to reduce non value added activities.

Table 2 provides examples of the types of performance indicators that agencies can use to measure themselves against both standard and best practice, at a point in time and over time.

Following is an outline of the possible uses of some of the measures of effectiveness in accounts receivable management:

Debtors turnover - This ratio measures the average period for which sales revenue will be held in accounts receivable. This measures the efficiency and effectiveness of receivables collection.

Accounts Receivable to Revenue ratio - This ratio can be used to highlight trends in the level of investment in accounts receivable. Where accounts receivable as a proportion of monthly revenue exceeds an established bench mark, thereby indicating the possibility of interest foregone, the matter can be highlighted for management attention.

Receivables Aging Schedule - This schedule is a listing of debtors by aging category. Analysing this schedule allows Accounts Receivable management to spot problems in accounts receivable early enough to protect the agency from major revenue problems. It may also assist in highlighting individual delinquent accounts.

In addition to measuring the effectiveness of the accounts receivable process as a whole specific debt collection techniques and their effectiveness should be monitored. This information can be used when assessing alternative debt collection strategies. It is of assistance when conducting assessments of this type to be cognisant of the costs of the relative collection strategies.

An important consideration in this process is the cost of measuring and analysing

performance data. Where possible agencies should seek to have performance information on activities such as accounts receivable part of their Financial Management Information Systems. The current move of Commonwealth agencies from cash based accounting systems to accrual systems presents an opportunity for agencies to include the production of performance information as a feature of any new systems.

It is also critical that reports be timely, present information in a readily digestible fashion and that they are directed to the appropriate levels of management. Reports presented to higher levels of management are more effective when they are presented in summary form, often with table or chart form presentations. Reports containing too much data are unlikely to be effective. Better practice would be to obtain management input into the design of reports to ensure that the reports are used as intended. A good starting point in designing management reports is to carry out a survey of users to establish what they like and dislike about the current suite of reports.

Table 1 - Example of Value Analysis of Accounts Receivable Activities

Activity	Value Hours	Current % Time	Current Hours	Target Time	Target %
Set price	VA				
Grant credit	BR				
Make sale	VA				
Issue Invoice	BR				
Update receivables ledger	BR				
Deal with customer inquiry	NVA				
Receipt payment	VA				
Issue monthly statement	NVA				
Issue letter of demand	NVA				
Determine repayment schedule with debtor	NVA				
Match payment to invoice	BR				

Code: VA - value adding; NVA - non value adding; BR - business requirement

Table 2 - Suggested performance indicators

Indicator	Current	Target	Common Benchmark	Best Practice Bench mark
<i>Efficiency Measures</i>				
Invoices processed per Full Time Equivalent (FTE) staff member per month			1000	5000
Remittances processed per FTE per month			2000	8000
Debtors contacted per FTE per month				
Direct labour cost per invoice/remittance/debt collection action				*
Cost of accounts receivable as a percentage of revenue from credit sales			0.3%	0.15%
Cost of accounts receivable as a proportion of total administrative costs				
<i>Effectiveness Measures</i>				
Accounts Receivable as a percentage of total revenue			#	
Debtors turnover ie. average time to collect			30 days	23 days
Debt written off as a percentage of total debt			10%	1%

Doubtful debts as a percentage of total debt	f	
Percentage of debts collected within terms of trade	50%	90%
Debtors by age group as a percentage of total debt -aged 30 to 60 days -aged 60 to 90 days -aged > 90 days	30% 20% 15%	15% 10% 5 %
Proportion of debts settled by electronic means, ie. EFT	10%	100%

* costs will vary with the nature of invoice production and issue, the nature of remittance and the type of debt collection action

dependent on nature of business

f a relatively low figure will indicate better practice, however, the level of doubtful debts will be influenced by factors outside accounts receivable management such as accounting policy

Appendix

The following is a checklist of features which should exist within a good policy or procedure document.

The policy is endorsed by an Executive Officer

The policy is based on a risk assessment of the agency and it's customers. This is recognised in the document by stating the risk factors.

The policy:

- Explains the nature of debts and debtors*

- *Outlines the agency's rights and duties with debtors; and legal consequences.*
- *Details the terms of trade and circumstances when a delegate may change the terms of trade*
- *Identifies other related procedure manuals, legislation which can guide processing of debts.*
- *Outlines mode of payment accepted and under what conditions (eg any transaction less than \$1000 must be by credit card)*
- *Identifies mechanisms for reviewing requests from debtors*
- *Outlines general procedures for handling unusual requests or events*
- *Outlines who is responsible for debt collection*
- *States how and when to communicate with a debtor regarding an overdue amount*
- *States procedures to recover debts from employees*
- *Lists options for recovering an overdue debt (eg allow instalments)*
- *Describes the use of commercial debt collection agencies*
- *Identifies whom has the authority for determining the mode of collecting an overdue debt (eg. instalments) and identifies circumstances to guide the decision.*
- *Identifies when to record a debt as overdue (including whether a period of grace applies).*
- *Details procedures for imposing charges*
- *Details the preparation of and requirement for certain report production*
- *Identifies means of monitoring debts*
- *Outlines the process of managing dishonoured cheques*
- *Lists circumstance when debts no longer need to be pursued and whom has the authority to decide not to pursue a debt*
- *States clear and comprehensive standards of performance (including the desired relationship with the customer) and targets for the timing of debt collection (eg. 80% within 30 days from date of invoice).*
- *Details the requirement to review the policy and procedures - when, by whom.*

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